DOW THEORY LETTERS INC.

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THE MARKET: The single hardest thing to do in the stock market is to remain objective, to avoid preconceived notions. In this business, and I mean the investment advisory service business, when you make a statement or put an opinion down in print, you obviously hope that opinion comes true. And why not? If you can be right often enough, everybody on Wall Street starts referring to you as a "genius" and a "seer." And the first thing you know, Time and Newsweek are calling you, and then comes the Wall Street Journal and your town newspaper and the local investment club. Subscriptions pick up, and your ego starts inflating. If you're not careful, your inflated ego will expand like a hot air balloon and damn near lift you off the ground.

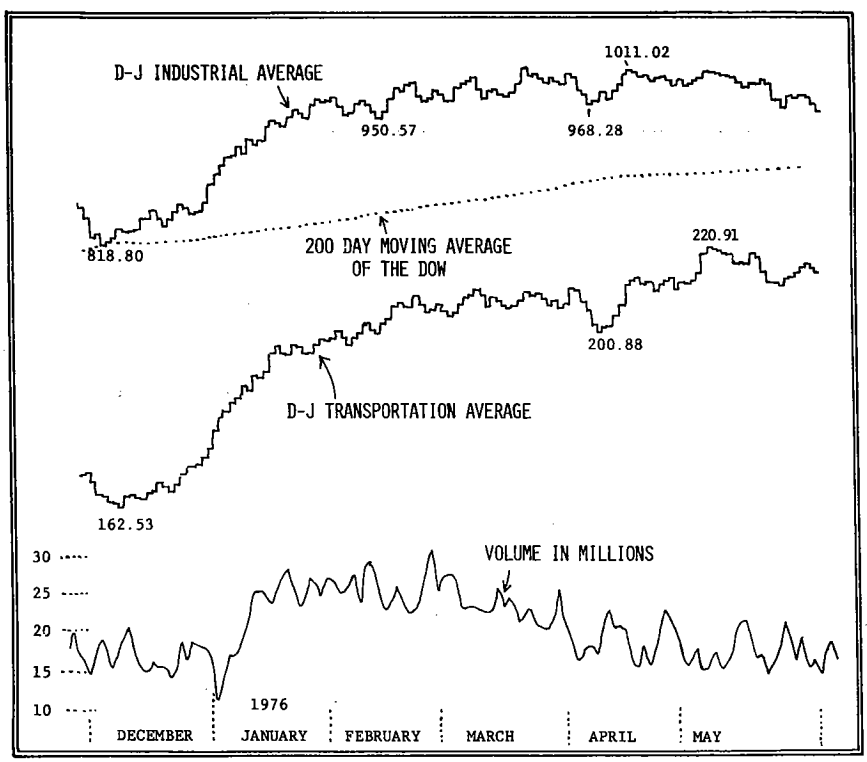
One of the best ways of avoiding all that nonsense is to let the market do the talking (as I've suggested to a number of advisors in this business). Such procedure, although not as dramatic, may save you and your subscribers a lot of grief and money. And it may even save your ego from the well known inflation-collapse syndrome.

So saying, let's cut out the chatter and get down to what this very difficult, very deceptive second phase of the bull market may be telling us. At this point, what do we really know? Well, psychologically speaking we know that Wall Street is a bit puzzled and disturbed about the coming "up for grabs" election. My analysis is that Jimmy Carter comes over wishy-washy on TV, and he may have peaked in popularity. But the really interesting story is that Mr. Ford is now fighting for his political life. And it looks increasingly possible that California's own Ronnie Reagan may get the Republican slot. If that comes to pass, then Mr. Carter has an excellent chance of moving into the White House (I just do not believe that Reagan can win, and it has nothing to do with God being on Jimmy Carter's side).

There's been much talk about the overwhelming bullishness of the advisory services, and this is supposed to be bearish for Wall Street (contrary opinion, you know). Personally, I am aware of only a few advisories that really expect the market to go up here. I continue to think that too many advisors are tabulating "all the other advisors," and I think the bullish-bearish theory is being overdone.

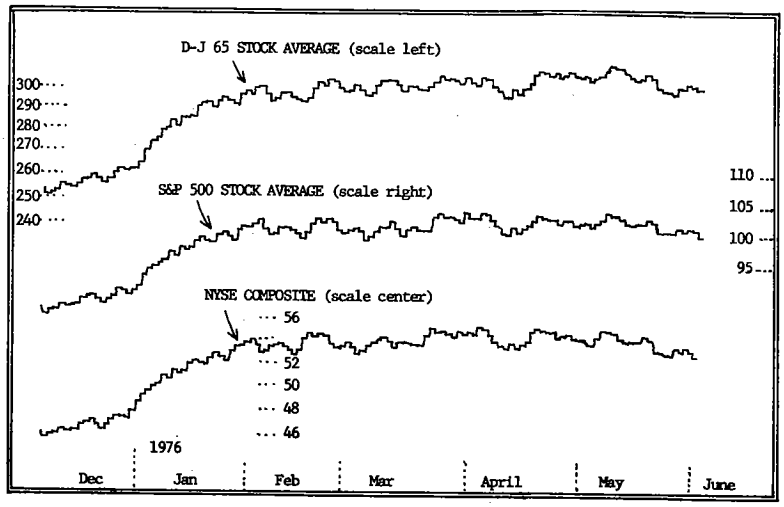
Next comes money. Here, I feel again that too many amateurs are crowding around the Thursday Dow Jones news tape, hanging on every word and statistic that comes from the Fed. Six months ago Wall Street was crying because the money supply "wouldn't go up." Now they are wailing because "it's going up too fast." According to Tony Boeckh, the Editor of the authoritative Bank Credit Analyst, "The money and credit indicators maintained their strong underlying cyclical trend this month." (He's talking about May, in his latest report). Boeckh states further, "Liquidity in the banking system continues to build. . . . The latest reporting period shows a $3 million increase in bank holdings of Government securities."

Now, let's turn to the stock market. First, I want to talk about Dow's Theory, which often serves me well when all else fails. Referring to the chart at right, we see a continuation of the phenomenon which has held in force since mid-1975. That phenomenon is the superior relative strength of the Transportation Average (superior to the Industrial Average).



Yes, the Transports have been acting extremely well, but consider this carefully. There has been a lot of uninformed talk of late about why it's bullish if the Transports outperform the Industrials. This is pure bunk, and it won't hold up in fact. A study of market history shows any number of instances in which the market has collapsed following an Industrial non-confirmation of a new Transport high (in other words, strong Transports and weak Industrials). What does interest me is the simple matter of non-confirmation. And I don't care which Average refuses to confirm the other. The second factor I watch for is whether a non-confirmation occurs in harmony with the primary trend or against the trend. In other words, I will take it bullishly if a downside

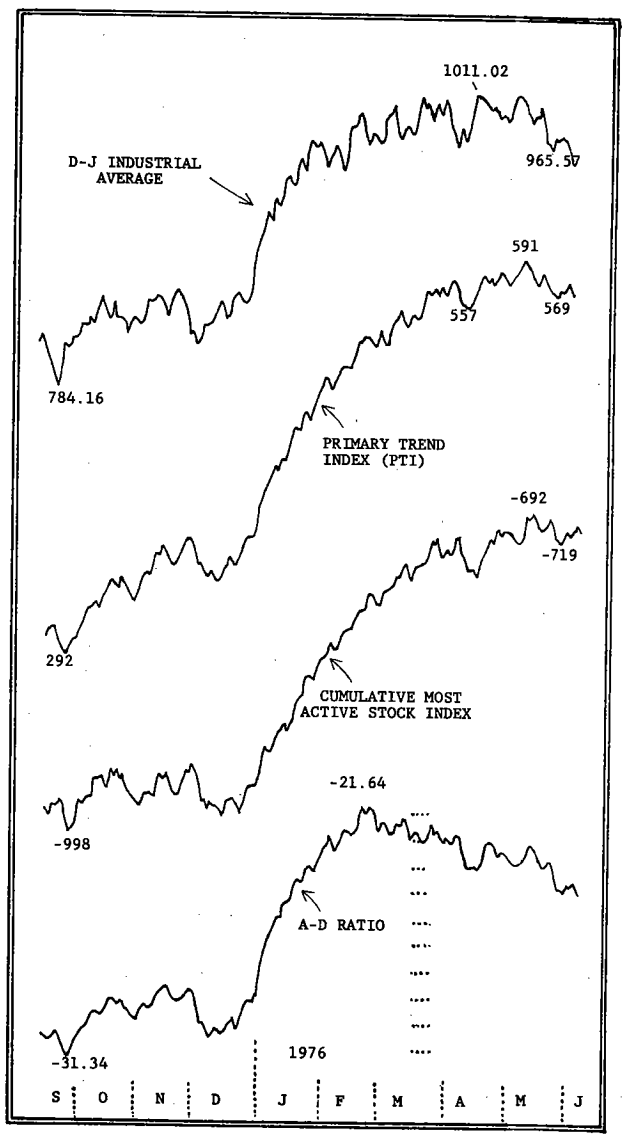
non-confirmation occurs during a bull market, and I will be somewhat skeptical if the same event occurs during a bear market.



On May 11 we saw Transports rally to a new bull market high of 220.91. This high was unconfirmed by Industrials, that Average having recorded its bull peak on April 21 at 1011.02. This action set the stage for a general market retreat with the strong possibility that the downside ranges (April lows) would be tested. Why was this? It was logical because if Wall Street's optimists can't gather a following on an advance, then the ball usually passes to the bears, and the game becomes one of whether the bears can gather a following on the downside.

The first downside test came on May 27, when Industrials (see page 1 chart) broke below the April 12 low of 968.28. This is what I suggested might occur (see last two Letters). With Industrials sinking below 968.28 to 965.57 (May 27), it was the Transports that refused to confirm. Volume on the solo Industrial penetration remained low, and this set off a rally. Whether the rally was more than "just a rally" remains to be seen. But the up-move, following a downside non-confirmation has served to do one thing. It has used up time (and time in a bull market works in favor of the bulls). The rally has also kept the price structure intact and well within the general definition of a "line formation." This too I feel is constructive. The line structures are revealed even more dramatically on the accompanying chart, a chart which pictures three of the best known composite Averages, the D-J 65, the S&P 500, and the NYSE Composite (the latter includes all 1532 common stocks on the NYSE). As we move into June, all three of these composite Averages are holding within their line limits of the past four months. If the market is "breaking down," we don't see it here yet (sure, I know that many individual stocks have corrected sharply, but when the market really breaks down, you see it in the Averages).

Next I want to examine the technical underpinnings of this market, which are (to say the least) fascinating. Study the chart of the Dow and the three indicators at the bottom of page 2. I've rarely seen such a mixed picture in these four profiles. Ponder this. We already know that the Transportation Average did not confirm when the Industrials broke below 968.28. But note that the Primary Trend Index or PTI (which is my own amalgam of eight critical indicators) has also refused to confirm on the downside. On the decline to May 27, the PTI held 12 points above its April 12 low, then pushed higher. The trend of the PTI is still bullish with ascending peaks and bottoms.



The same can be said of the Cumulative Most Active Stock Index (CMAS). This is simply an advance-decline line of the 15 most active stocks on the NYSE (daily). I have termed this index an A-D line of "big money," and it often leads the market. On May 27 the CMAS refused to confirm on the downside, and as of now the CMAS remains in a mild upward trend.

Finally, we see that the A-D ratio for the NYSE has been sliding lower ever since its February 24 peak. The clear indication is that the majority of stocks have been correcting for over three months. But so far the A-D correction has been quite shallow, and at the May 27 low the A-D had given up only 3.10 points of the 8.71 points it gained during the December, 1975 to February, 1976 "buying stampede." If we were in a primary bear market, I would be worried sick about the February to April divergence between the Dow and the A-D ratio. But it's a bull market, and therefore I'd prefer to give the market every benefit of the doubt. Bull markets have a way of absorbing a ton of bad news (such as the collapse of the pound and the current cooling off of retail sales) plus a lot of technical problems and then straightening themselves out. That process would be occurring now.

Conclusion: As noted in the last report, we've seen 1976 peaks on all the indicators. We've had bad news, we've had technical divergences, we've heard bearish predictions. But as of this writing, the D-J Averages have not given us the signal to run for the storm cellars. Currently the Transportation Average is 15 points above the 200.88 level, and that is the level which would have to be broken before Dow's Theory could

signal danger in the form of a full-blown secondary reaction. I'm not saying that 200.88 is impregnable, but time is passing and the 200.88 level on Transports still stands. Remember this (and it's very basic Dow Theory, so basic that it's easy to overlook): valid inferences regarding the trend require action by both Averages. A penetration by one Average, unconfirmed by the other, is meaningless and more often than not, deceptive.

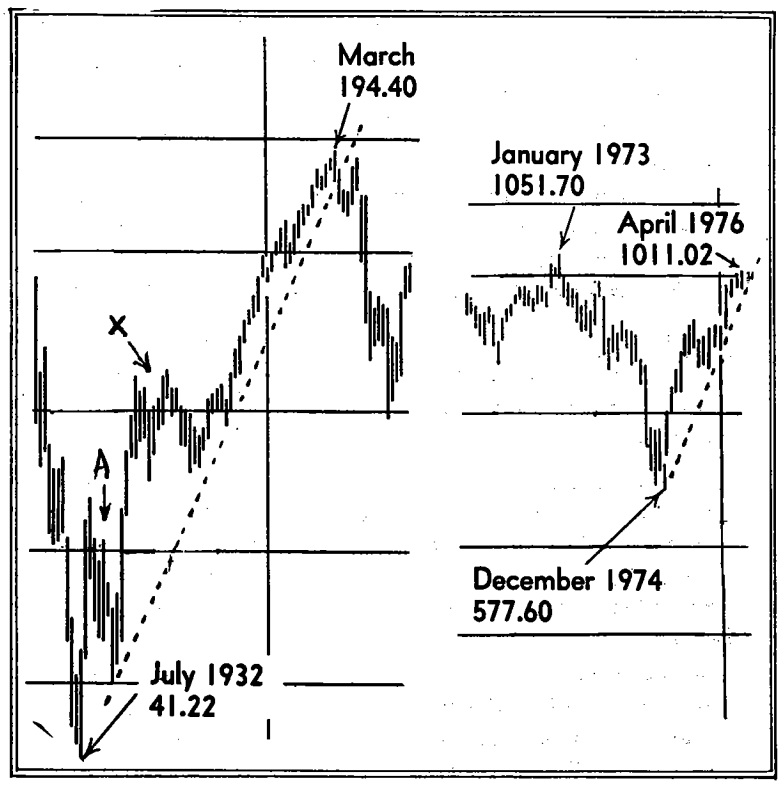
All in all I feel that the market is dealing with two technical problems. The first, as I noted in previous Letters, is that the angle of ascent for the Dow is too steep. It must be lowered, and that means pressure for sideways or downward movement. But the second force is that of the primary bull, and this is the force which so far has been resisting decline. The net result has been sideways or line formations in all the major Averages. I expect this situation (boring and frustrating as it is) to last somewhat longer. And that means a trading range for the market, with selectivity in individual stocks (some making good gains and others correcting). This kind of market, despite what the geniuses tell you, is a tough market to make money in.

Question: Russell, what happens if the market turns down again and everything starts sliding lower? If that happens it could be a few weeks before the Transports break 200.88. Wouldn't we lose our shirts if we held stocks until Transports gave their half of a bearish signal?

Answer: We probably would, but we now have two little "insurance points." Transports held at 211.35 on May 27 on the day when Industrials hit 965.57. If a new decline takes both Averages below those points on expanding volume, it would pay subscribers to be very careful, and perhaps lighten positions. But it would still require a breaking of 965.57 and 200.88 for a definitely bearish signal. The first set of figures simply provide a nearby, sensitive insurance level.

DROP IN CONFIDENCE: For over a month I have been drawing attention to the fade-out in relative strength (RS) in the various consumer stock groups, groups such as Motion Pictures, Publishing, Toys & Games, Leisure Time, Hotel-Motels, Supermarket Chains.

Last year I published a chart showing the path of the Dow and Barron's Business Index during the dramatic period of the 1930's. I want to go over that period again, because I still feel that there are definite similarities between what happened in that confusing and difficult period and what is happening now (see charts on this page).

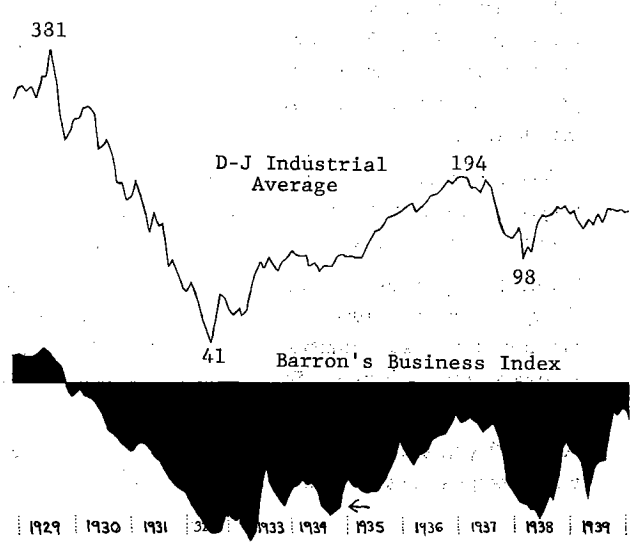


The Dow Industrials dropped 89% from their 1929 peak during the 1929 collapse. By the same token, during 1968 to 1974 the unweighted stock averages dropped anywhere from 75% to 85%. Then, the low for business came in 1933, the year after the market bottom. The low for business in the recent situation occurred in early 1975, the year after the 1974 crash bottom.

Then, the Dow roared up from its 41 low of July, 1932 to a peak of 108 in 1933. A correction carried into October of 1933, following which the Dow pushed to a February, 1934 high of 110. Then came an eight months reaction into October, 1934. As you can see on the chart, this 1934 reaction coincided with a relapse in business. It wasn't a new bear market, and it wasn't even a business recession. It was a kind of consumer slump which lasted until late-1934. From that point, the market and the economy turned up again, both expanding steadily through 1935, 1936 and the first quarter of 1937.

During this entire period, the nation was beset with the most severe problems. The Government with its myriad new agencies tried to take credit for the business improvement. But many businessmen, writing at the time, stated that the economic expansion of 1932-37 occurred despite the Government efforts, not because of them. When quizzed about the great improvement in business (during 1936), Mr. Roosevelt arrogantly replied that it happened because "We planned it that way." His words came back to haunt him when, during 1937, the stock market collapsed and Barron's Business Index dropped in half. (A primary bear market started in April, 1937).

Today, we could be witnessing a rough repeat of 1934. The stock market has had a great rise. Business has improved substantially from the 1975



 recession lows. Business profits have risen dramatically. And suddenly, we find the consumer turning cautious again. Huge problems are besetting the nation, just as they did during the 1930's.

I am aware that times are very different now compared with the 1930's. For instance, the entire debt structure today is massive, whereas in the 1930's it was much smaller and more manageable. Today people are fuming about crooked politicians, but of course the 1930's had their share of committees which investigated every phase of "The Great Crash." Interest rates and inflation are two of today's monster worries whereas in 1934 it was unemployment and insolvencies and in many cases the problem of just getting "three squares" a day.

The point I am trying to make is that each era has its own peculiar, "terrible problems," and I must admit that I (like everyone else) feel that today's problems may be worse than those of 1865 or 1907 or even 1929. Nevertheless, if sanity reigns today as it ultimately did in the past, we should be able to solve the current maze of potential disasters. "But in 1929," the pessimist tells me, "the national debt was only $16 million, with a US population of 120 million people. Now we have to pay $35 million just for interest on the national debt, get that — interest on the debt, with a population of 210 million. It can't go on, we're going off our rockers!" And on one level I agree, and that's why I write pieces on the dangers of debt and mindless spending. But I also have to deal with timing, and I don't think the time of reckoning is here—yet. Not while this bull market continues to be in force.

In a follow-up to my angle of ascent piece in Letter 664, page 2, I am again presenting comparative charts of 1932-37 and the 1974 bull market to date (chart courtesy of M/G Financial Weekly). Referring to the 1932-37 bull market, the first correction off the bottom (labeled "A" on chart) occurred during 1932-33, and I would say that this was roughly comparable to the late-1975 action of this bull market. Both corrections served to end the first phase of their respective bull markets.

The second correction in the 1932-37 affair occurred during late-1933 to 1935 and early-1935. It served to consolidate the bull market, to move it sideways, and to bring the angle of ascent down. All this occurred during the early to middle part of the second phase of the 1932-37 bull market. I believe we are seeing the same kind of action today.

As I said in Letter 664, the 1932-37 angle of ascent was the steepest of any rise in modern history. No market rise since then has been as steep. And here lies the problem. The 1974-76 angle of ascent is even steeper than 1932-37! This means to me that the current market is going to have to do something about it — either by way of correcting or by moving generally sideways. It's necessary, it's vital for the health of this bull market. So once again I'll say, don't get discouraged because the market isn't at 1100 here in June. I believe we'll get there — when Wall Street is ready.

ALTERNATIONS: One of the most mystical (but surest) phenomenons is that of alternating impulses. Up until 1973, many economists and even a few technicians were ready to go on record to the effect that there would never again be a major bear market or a severe economic recession. The years 1973 and 1974 went a long way toward clearing Wall Street's and Washington's minds on that one.

Yet the pulsating or alternating phenomenon is one of the most obvious facts of the world around us. There is night and day, life and death, love and fear, winter and summer, depression and elation, poverty and wealth, radicalism and conservatism, and on and on. I recently watched a motion picture which dealt with one of the most basic organisms, slime mold (which is little more than a jelly-like mass of protoplasm). Scrutinized under the microscope, it was clear that this "jelly of life" was expanding and contracting, moved, it seemed, by an invisible force. Thus, even the slime mold was acting according to the principle of alternation.

The Eastern mystics (and many Westerners) believe in Karmic principles which state that every action you take produces a reaction which will be felt in this life or the next. For instance, if you are unjust to your neighbor, your injustice will be returned to you, in perhaps another form, but nevertheless it will be returned. By the same token, your kindnesses will be returned in kind; your good deeds will be given back to you in the form of good deeds from another.

"It sounds crazy," says the Westerner. "I don't believe it for a second. What scientific basis do we have for that one?" But even the scientist (if pushed) would admit that a stone, dropped from your hand, must displace particles and atoms which in turn will have an effect on other atoms, and these in turn will extend their effect (no matter how miniscule) until like the ripples of a wave, your energy-waves will reach out across space and finally return to you, the stone-dropper. If that can be, why cannot the Karmic laws be?

Taken a mystical step further, why can't a bull market be the result or reflection of the consciousness of millions of people, the majority of which are in a positive or constructive phase. And couldn't a bear market be the alternation or the reaction to the abuses of the bull market, a sort of karmic return of greed, grabbing, touting, rumor-mongering and profiteering?

"Possible," you retort, "but where does all this get us? Actually, of what use are bull and bear markets in the grand scheme of things?" And my answer is that they offer us a study in mass psychology and consciousness second to none. They act as a sort of barometer of mass evolution. I firmly feel that each generation of humans evolves to higher states of mind, and that free markets evolve to higher levels. For those willing to read the "bloodless verdict of the market," the Averages offer an emotionless gauge of capitalism and free enterprise as it exists at any given time.

"Great," you say, "and what is the market telling us today?" There I pause, "The Dow at 900-1000 is saying that capitalism and free enterprise hasn't made any real progress in a decade. We're still in the same general area that we were in during 1966. Per-

sonally, I don't know whether we are witnessing the beginning of the end for the free enterprise system or not. But I do know that it is debt, the "mortgaging of tomorrow," that is the noose around the neck of the nation. Maybe I'm a conservative at heart, but I've always felt that debt was a way of getting something you don't need or deserve, with money that isn't yours, at the expense of interest rates you can't afford.

In closing this section, I want to quote from a book I have been reading by the late Talbot Mundy, a brilliant writer, philosopher and novelist. The book is titled "I Say Sunrise." "Debt is the most stupid and stupifying of all mankind's many inventions. A nation in debt is a nation of fools. You can't pay all the world's debt. Very likely, at the moment, you can't even pay your own. But if you have made your turn towards Wisdom you are already on your way out of debt. You are on your way out of debt when you realize that the whole system of public and private debt is a lie. Railing at debt and cruelty won't help you. Resentment won't help you; quite the contrary, it will make the chains seem more unbearable. But consciousness of the eternal affluence of Wisdom and its everlasting now-ness will lead you out of debt, and will lead others, also, because your consciousness will change theirs. Once out of debt, stay out!

"You don't stop a dog fight by going down on your hands and knees and fighting dogs with your teeth. And you can't cure the world's financial condition (or your own) by attempting to manipulate facts. Debt is debt. Poverty is poverty. They are states of consciousness. Debt begets more debt. Poverty begets more poverty." (Written in 1946).

* * SUNDRY ITEMS * *

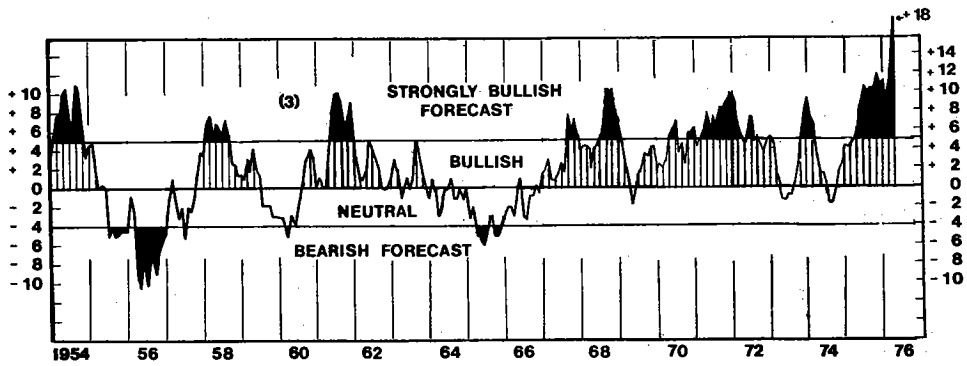
THREE DOW MOVING AVERAGES: I haven't mentioned the moving average (MA) study of the Dow since Letter 660. But I want to mention it now. On May 27 the 4-week MA of the Dow sank below the 13-week MA—a 1976 first. This is what I term a "sell alert." The 13-week MA (now at 990) is still 91 points above the 50-week MA (which stands at 899), and this is the more important relationship. Major sell indications occur when the 13-week MA plunges below the 50-week MA, and this has obviously not occurred.

But the current sell alert (4-week dropping below the 13-week) is an "insurance signal," although I personally have often lightened up when these signals have occurred. Remember that (1) the sell alert signals are most important when they occur in harmony with the primary trend (this one did not), and (2) the sell alert signals often produce whipsaws, whereas the major sell signals tend to be fewer and much more important.

POLITICS: I haven't included a quote from my old friend Eliot Janeway for a while, but to my mind this one (from the June 2 Janeway Letter, 15 E. 80 St., NYC 10021) is definitely the quote of the week. "The Campaign may be failing to bring issues to a head; but it is bringing personalities to the fore. The sorry spectacle of Ford on trial to beat Reagan in a Republican primary, and needing Democratic crossover votes to win in his own state, is a preview of a Democratic landslide. A Ford deal to take Reagan or Connally as a running mate would not reverse this trend any more. The securities markets are already adjusting themselves to a Democratic victory; that's one good reason why the influential prediction of a 100-point break, in the course of high volume, for the Dow Average has not materialized. Where a Republican Administration makes management feel comfortable and wrecks the market for stocks, a Democratic Administration upsets management and buoys stocks. The stock market is now making the turn and building a base for its post-election surge."

What could this mean? If Uncle Eliot is correct, then we'll have a Democratic Administration in 1976, super-big spending coming in, pressure on the Fed and Mr. Burns to get their hands off the brakes (maybe even pressure to get rid of the Fed), and probably a third phase of the bull market. And then — well you read what I wrote about "alternation."

DEBIT - LOAN RATIO: Occasionally, studies which I follow behave erratically or produce something in the way of a new record. I have been watching the Bank Credit Analyst's debit-loan ratio for many years, and of late it has literally "blown off the top of the chart." The ratio is based on bank debits and loans. When loans are expanding rapidly but business activity (debits) are sluggish, the ratio falls. But when business activity is active in relation to loan demand (as now), the debit-loan ratio climbs. Today's climb to the 18 level is a whopper, and would seem to be a prediction of much better business ahead. At any rate, I thought the chart was well worth studying (chart courtesy of BC Analyst, 1245 Sherbrooke St., Montreal 9, Canada).

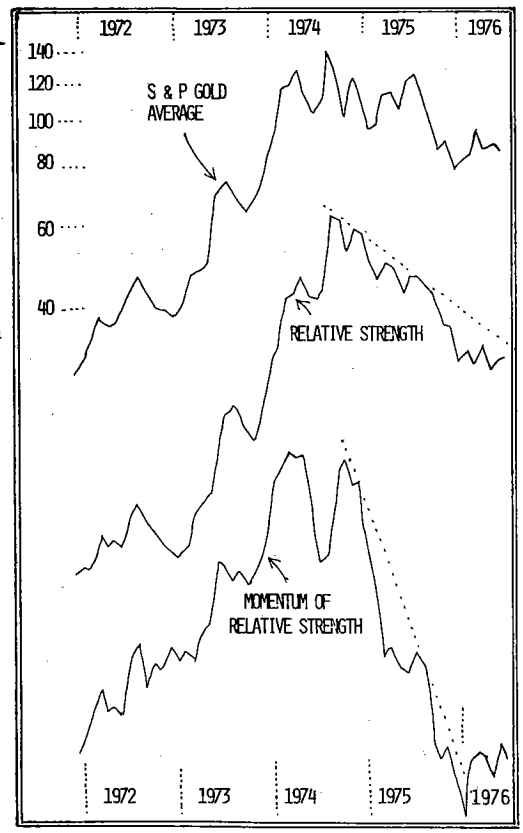


D-J AVERAGES CHART BOOK: Orders for the new chart books have been coming in extremely well. The book will contain daily charts (one page per year) of the D-J Industrials, Rails (Transports), Utilities and Bonds with volume. Important points on all the Averages will be marked and outstanding historical events will also be notated. The charts are going to be even better and more informative than I expected, and to say the least I am getting very enthusiastic about them. Therefore, I urge all of you to place your order for one of these albums. To me, it's simply fascinating (and useful) to see what the Utility Average did in 1929

or what the 40-Bond Average did during World War II or what the Industrials and Rails did during the San Francisco fire of 1906.

The first printing (thanks to my enthusiastic subscribers) has already been expanded, but I need to know as soon as possible how many books to print. The chart books will be loose-leaf, hard cover, charts to be on 11½ X 17" heavy paper. Charts will go back through 1885 daily. This is the first time that daily charts of all four of the Averages plus volume have ever been offered for sale. Price is $49 ($52 for Californians). We pay the mailing costs on domestic shipments. We cannot bill. Books should be ready for mailing in July. But please help me bv sending in your order now.

GOLD: Well, the first IMF gold auction came and went, and my opinion — that January, 1976 saw the gold bottom at 124 has not changed. Despite the relative inactivity of gold over the past few months, I have an extraordinary number of subscribers who remain extraordinarily interested in gold. I guess that no amount of pious promises from politicians can bring about confidence in the future of paper money.



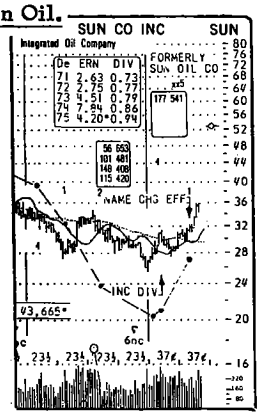
I'll restate my gold position again. I think that gold bullion has bottomed out, and that "survival positions" in gold coins such as Krugerrands are perfectly all right. I can't tell you exactly what percentage of your assets you should be holding in coins, maybe 5% to 10%, depending on your pessimism regarding green paper. I see nothing wrong with small positions in Dome or Homestake in Western Golds, and perhaps speculative positions in such S. African high-cost producers as Loraine, Harmony, Kinross, Western Areas. The last four are highly leveraged shares selling at low prices, and they should be viewed as "perpetual warrants" or calls on an eventual high price for gold and a simmering down of the S. African political situation (both of which could certainly occur). To give you an idea of the leverage factor, Loraine is now under 2 but at its old high was just under 12. View these stocks as a pure speculation, however. Put the money down and forget 'em. If S. Africa goes, your holdings of Loraine will be your least worry.

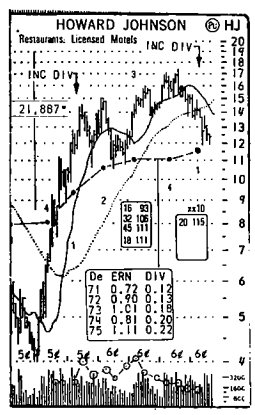
I am including my Ray*Signals chart of Gold and its relative strength. For cold, market-oriented subscribers, the fact is that the Gold group has not yet reversed its downtrend in relative strength. Until it does, gold holdings will not interest market "hard noses." When gold finally does turn up in RS, this crowd of subscribers will buy golds just as if they were Auto stocks, Office Equipment or any other group. Suffice it to say that I will recommend gold purchases for all (believers and non-believers) when this chart says "Go."

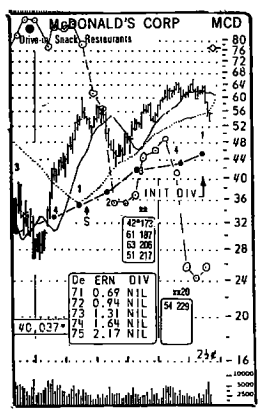
LATE MARKET NOTES, STOCK NOTES: On March 4 the Dow Industrials hit a 970.64 low. Then came an April 12 lower bottom of 968.28. Next came the May 27 still-lower bottom of 965.57. As this is written Industrials have broken again. Strangely, the Transports recorded a low of 200.88 on April 9, and have not been lower since. Watch the May 27 Transport low of 211.35 (see page 1 chart). If that holds, I would say that the market is much more hopeful than the overt action of Industrials implies. If 211.35 is broken, watch 200.88. That's a critical level in the current market structure. Utilities and Bonds appear to want to "stop going down." If true, that will be a positive influence on the market.

As far as stocks are concerned, the downside reversals in relative strength continue to be in the consumer sector. For June (courtesy Ray*Signals, 143 Lake Ave., Montrose, PA 18801) the Electrical-House Equipment group (Maytag, Whirlpool), plus Restaurants, Department Stores and Drug Stores groups are down in RS. Of particular interest is the downturn in RS in McDonalds which is now below its 1975 high. Howard Johnson, Denny's and the rest of the groups are also slipping. This is probably a case of super-saturation in terms of both fast-food restaurants and the shares of these companies. A second thought: the novelty of "eating out on the corner" is beginning to wear off. And perhaps the novelty of good, low-calorie, home-cooked food is beginning to sink in. (Small charts courtesy of Quote, PO Box 213, Wichita, KA 67201).

The single bullish upward reversal in RS for June is Auto-Trucks and Parts which includes Cummins Engine and Fruehauf. Only one other individual stock turned up in RS, and that was Sun Oil.







FLIPPING OUT? La Jolla, a suburb of San Diego with a population of 27,000, now has 10 brokerage houses or one for every 2700 residents. (Merrill Lynch, Bache, Dean Witter, Bateman Eichler, Shearson, Sutro, Paine Webber, Loeb Rhoades, and Eastman Dillon on the way!) I expect the New York Stock Exchange to move here around September with maybe the Amex by December. C'mon boys, there can't be that much bread here! Could it be the weather?

Next mailing: June 18th